The Move: Understand asset allocation

Knowing just a few asset allocation basics can help you develop your investment strategy.
Determining your asset allocation is an important first step in choosing investment options in your workplace retirement plan. Asset allocation is how you divide your savings among different investment types such as stocks, bonds and short-term investments. Here, we highlight four basic steps in developing your asset allocation strategy.

**Step 1**

**Understand the asset classes**

Consider that your choices generally focus on three things: stocks, bonds and short-term investments. These three types of investments are known as the basic “asset classes”:

- **Stocks**, also called equities, are shares of ownership in a company.
- **Bonds**, also called fixed income investments, are loans made to governments or corporations.
- **Short-term investments**, also known as cash equivalents, are designed to maintain their dollar value. Examples include money market funds, certificates of deposit and Treasury bills.

Although the investment menu in your workplace plan may have many options, most will fall into these basic groups – or a combination of them.

**Why it is important**

Studies have shown that up to 91% of your investment return can be based on your asset allocation rather than the specific investment options you choose, so it is a good idea to spend some time figuring out your strategy.¹

Each asset class has different characteristics that you should be aware of. Historically speaking, stocks have posed greater investment risk than the other asset classes, but have offered the potential for the highest return. Short-term investments have offered lower returns in exchange for low investment risk, yet may not always keep pace with inflation over all time periods. Bonds tend to fall somewhere in the middle.

### Comparing asset classes

The chart below shows the average annual return percentage for the three basic asset classes, compared with inflation, for the 30-year period of 1982-2012.

![Asset class comparison chart](image)


Step 2
Know your tolerance for risk

How much risk you are comfortable with is an important consideration when choosing your asset allocation strategy. How do you feel about investment risk – the chance that your investments could lose money? You also need to think about inflation risk – the risk that conservative investments such as short-term investments may not keep pace with inflation.

Investing in more than one asset class – or a blend of them – may help to balance your risk. Mixing the various investment types can provide a balance of growth with preservation because the markets for each investment don’t always move in the same direction as each other. ²

Step 3
Establish your time horizon

Your tolerance for risk must be considered in the context of your time horizon. Do you have some time until you retire or are you getting closer to retirement? In the short term, the most volatile investments, such as stocks, can rise and fall dramatically. Historically, however, they have outperformed all other investments over the long term.³

If you need your money within the next few years, you might want to avoid putting a large percentage into a single asset class that could dip in value in the short term.

On the other hand, assuming you have six years or more before you will need your money, you may consider investing a percentage of your savings in investments that offer greater potential for return. That’s because you have more time to potentially ride out short-term fluctuations in the value of your investments.

Step 4
Determine your asset allocation strategy

The participant web site offers tools and resources to help. To determine which strategy may be right for you, check out the Investment Questionnaire on ppd401k.com.

Revisit your strategy once a year and after major life events to ensure it is still in line with your current needs and outlook. You may want to consider adjusting the proportions of stocks, bonds and short-term investments as you get closer to retirement. Remember, everyone’s situation will differ, and you should consult a financial advisor about your own particular situation.

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